

DHS SBIR Cost Matching Guidance

This paper contains official guidance on what types of relationships between a small company and outside investors in the company qualify as an investment under the DHS SBIR and STTR Cost Matching Program. It includes specific examples of company-investor relationships that we have been asked about and our official responses on whether these relationships qualify as a Cost Matching investment. If you have questions about whether a particular company-investor relationship qualifies, please contact the DHS SBIR Program Manager, Lisa Sobolewski, e-mail Elissa.Sobolewski@dhs.gov, or Jonetta Fantroy, e-mail Jonetta.fantroy@dhs.gov.

I. General Guidance on What Qualifies As A "Cost Match Investment"

The investor must be an "outside investor," which may include such entities as another company, a venture capital firm, an individual "angel" investor, a non-SBIR/non-STTR government program, or any combination of the above. It does not include the owners of the small business, their family members, and/or "affiliates" of the small business, as defined in Title 13 of the Code of Federal Regulations (C.F.R.), Section 121.103. As discussed in that Section:

- Concerns are affiliates of each other when one concern controls or has the power to control the other, or a third party or parties controls or has the power to control both.
- [We] consider factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.
- Individuals or firms that have identical or substantially identical business or economic interests, such as family members, persons with common investments, or firms that are economically dependent through contractual or other relationships, may be treated as one party with such interests aggregated. Although DHS SBIR is guided by this definition of affiliation in the Code of Federal Regulations, we also exercise our own discretion in determining whether a particular entity qualifies as an "outside investor."
- The **investment** must be an arrangement in which the outside party provides cash to the small company in return for such items as: equity; a share of royalties; rights in the technology; a percentage of profit; an advance purchase order for products resulting from the technology; or any combination of the above. The investor's funds must pay for activities that further the development and/or commercialization of the company's SBIR technology (e.g., further R&D, manufacturing, marketing, etc.).

II. Specific examples of what Does and Does Not Qualify As a "Cost Match Investment"

A. Examples of What Qualifies as an "Outside Investor"

(1) Can a small company contribute its own internal funds to qualify for the Cost Matching?

No. DHS SBIR is seeking outside validation of the commercial potential of the company's technology, and therefore requires that the funds come from an outside investor. Also, cash from an outside investor shows up plainly on the company's books and therefore can be more readily verified than a company's own matching contribution.

(2) Company A spins off company B, which wins a phase I SBIR award. Company A then wants to contribute matching funds to qualify company B for the Cost Matching. Can A be considered an outside investor for purposes of the Cost Matching?

In making our determination of whether company A is an outside investor, we would be guided by the definition of "affiliates" in 13 C.F.R. Sec. 121.103, discussed above. Our presumption is that in this example A and B would be considered "affiliates," and that A would therefore not be an outside investor for purposes of the Cost Matching Program. However, that presumption could be rebutted by showing, for example, that the spin-off occurred several years ago and that A and B do not exercise control over one another, do not have common ownership or management, have different business interests, etc.

(3) Small company S wins a phase I SBIR award. The president of S is a major shareholder in another company Y, which wants to contribute matching funds to qualify S for the Cost Matching Program. Can Y be considered an outside investor?

Our presumption is that Y would not be considered an outside investor. Our determination would be guided by whether the president's stake in Y is large enough that S and Y would be considered "affiliates" under 13 C.F.R. Sec.121.103. Subsection (c.) of Section 121.103 specifically discusses affiliation based on stock ownership:

- Affiliation based on stock ownership.

1. A person is an affiliate of a concern if the person owns or controls, or has the power to control 50 percent or more of its voting stock, or a block of stock which affords control because it is large compared to other outstanding blocks of stock.

2. If two or more persons each owns, controls or has the power to control less than 50 percent of the voting stock of a concern, with minority holdings that are equal or approximately equal in size, but the aggregate of these minority holdings is large as compared with any other stock holding, each such person is presumed to be an affiliate of the concern. If S and Y are found to be affiliates, we would determine that Y is not an outside investor.

(4) Does the outside investor have to be a single entity (e.g., a single venture capital firm) or can it be more than the entity (e.g., two angel investors and a venture capital firm)?

It can be more than one entity.

(5) Small company A contributes matching funds to small company B in order to qualify B for the Cost Matching Program, and, at the same time, B contributes matching funds to A in order to qualify A for the Cost Matching Program. Do A and B qualify as outside investors under the Cost Matching Program?

No. A and B's relationship is such that their investment in each other would not provide outside validation of the commercial potential of their respective SBIR projects. We would therefore not consider them to be outside investors for purposes of the Cost Matching Program.

(6) Can the brother of an employee of small company S contribute funds to qualify S for the Cost Matching Program?

Probably not. Again, we would be guided by the definition of "affiliates" in 13 C.F.R. Sec. 121.103. The brother presumptively would be an affiliate of company S and not an outside investor.

(7) Venture capital firm V currently is a 22 percent shareholder in small company S. Can V invest additional funds in S to qualify S for the Cost Matching Program?

Our presumption is yes. In making our determination, we would be guided by whether V and S are "affiliates," as defined in 13 C.F.R. Sec. 121.103. Section 121.103 provides (in subsection (b)(5)) that a venture capital firm is not affiliated with a company if the venture capital firm does not control the company -- e.g., by owning more than 50 percent of the stock of a small company (prior to its investment under the Cost Matching Program), as described in 13 C.F.R. 107.865.

(8) Large company L makes a cash investment in small company S, and then serves as a subcontractor to S on an SBIR project. Can L's investment in S count as a matching contribution for purposes of the Cost Matching Program?

Only L's cash investment net of its subcontracting effort can count as matching funds for purposes of the Cost Matching Program. For example, if L invests \$750,000 in S and subcontracts with S for \$250,000, only L's net contribution (\$500,000) can count as matching funds for purposes of the Cost Matching Program.

(9) Company Y makes a cash investment in small company S for purposes of the Cost Matching Program, and also enters into a separate contract with S under which Y provides certain goods/services to S in return for \$500,000. Can Y's cash investment in S count as a matching contribution for purposes of the Cost Matching Program?

As in the previous example, only Y's cash investment net of the \$500,000 it receives from S can count as matching funds for purposes of the Cost Matching Program.

However, if the separate contract between Y and S pre-dates S's submission of its phase I SBIR proposal, Y's entire cash investment can count as matching funds for purposes of the Cost Matching Program.

(10) A group of investors wishes to invest funds in small company S to qualify S for the Cost Matching Program. One of the investors is the mother of S's president, who wants to contribute \$50,000 toward the effort. Can the group's investment in S count as a matching contribution to qualify S for the Cost Matching Program?

The mother's investment of \$50,000 does not count, because she is not an outside investor (see item (6) above). Contributions of the other investors can count provided that they meet the other conditions for the Cost Matching Program (e.g., each must be an outside investor).

B. Examples of What Qualifies as an "Investment"

(1) Can a loan from an outside party qualify as an "investment" for purposes of the Cost Matching?

No. The rationale behind the Cost Matching Program is that an outside party is betting on the company's success in bringing the technology to market -- not just its ability to repay a loan.

(2) How about a loan that is convertible to equity?

A loan that is convertible to equity at the company's discretion would count as an investment under the following circumstances: (1) the loan is provided by a public entity (e.g., a state agency), or (2) the loan is provided by a private entity, and the SBIR company actually converts the loan to equity before the end of phase I.

(3) Can in-kind contributions from an outside investor count as matching funds under the Cost Matching Program?

No. The matching contribution must be in cash. A cash contribution is a stronger signal of the outside investor's interest in the technology, and can be readily verified.

(4) Can a purchase order from an outside investor count as a matching contribution under the Cost Matching Program?

An advance purchase order for new products resulting from the SBIR project can count as a matching contribution under the Cost Matching Program. The purchase order must be for one or more products directly resulting from the SBIR project (including, for example, a duplicate of the prototype that will be delivered to DHS SBIR at the end of phase II). The investor must provide its cash payment to the small business during phase II, within the time frame set out in the solicitation (section 4.5). To ensure that the investor's funds are "at risk," the payment cannot be refundable to the investor if the product is not delivered or does not work.

(5) Can the funds raised from an initial public offering (IPO) count as matching funds for purposes of the Cost Matching Program?

Yes, as long as the offering memo indicates that a portion of the funds from the IPO will pay for work (e.g., R&D, marketing, etc.) that is related to the SBIR project.

(6) If large company L pays small company S for work related to S's SBIR project and expects a deliverable (goods or services) from S in return, would that qualify as an "investment"?

With the exception of an advance purchase order (discussed in (4) above), this arrangement would not qualify as an investment, for the same reason a loan does not qualify. Specifically, in this situation the large company is not betting on the small company's success in bringing the technology to market, but merely on its ability to provide the deliverable.

C. Examples Re: Timing/Logistics of the Cost Matching Investment

(1) Can entity E's investment in small company S during the first month of S's phase I SBIR project count as a matching contribution to qualify S for the Cost Matching Program?

Yes, provided that E is an outside and that the other Cost Matching Program conditions are met. The investment can occur any time after the start of the phase I project.

(2) Small company A, which has won a phase I award, spins off small company B to commercialize the SBIR technology. A then convinces angel investor I to invest funds in B. Can I's investment in B count as a matching contribution to qualify A for the Cost Matching Program?

For I's investment in B to qualify A for the Cost Matching Program, DHS SBIR must determine that A and B are substantially the same entity, as evidenced, for example, by their meeting the definition of "affiliates" in 13 C.F.R. Sec.121.103. If DHS SBIR determines that A and B are substantially the same entity, I's investment in B could qualify A for the Cost Matching Program. Of course, the parties must also meet the other conditions for the Cost Matching Program (e.g., I must be an outside investor).

(3) Small company S is collaborating with a university on an STTR project. Investor I wishes to provide funds to the university in order to qualify S for the STTR Cost Matching Program. Can I's investment in the university count as a matching contribution to qualify S for the Cost Matching Program?

In order to qualify S for the STTR Cost Matching Program, I's investment of funds must be in small company S, not in the university. S can then subcontract some of the funds to the university. The rationale is that a cash investment in the small company is a very strong indication of commercial potential, whereas an investment in the university is less so.

(4) Must the activities funded by the investor be included in the statement of work for the small company's phase II contract?

No. The investor's funds must pay for activities that further the development and/or commercialization of the company's SBIR technology (e.g., further R&D, manufacturing, marketing, etc.), but these activities need not be included in the phase II contract's statement of work. In practice, funds from private sector Cost Matching Program investors generally are not included in the phase II contract's statement of work, whereas funds from government Cost Matching Program investors (such as DHS SBIR acquisition programs) sometimes are.